Comments of Morgan Stanley Capital Group
In response to
Recommendations of the Market Advisory Committee
To the California air Resources Board
Of June 1, 2007

Morgan Stanley Capital Group Inc. (MSCG) has reviewed the Market Advisory Committee's (MAC) draft recommendations, issued on June 1, 2007. We believe the Committee's embracing of a source-based regulation approach wherever possible is crucial to the long-range efficient functioning of the electric power system in California. It will deliver the desired reduction in emission of greenhouse gas emissions at the least overall cost to society, and will do so without reducing the transactional or operational efficiency of the electricity sector. This importance of this last point, in MSCG's experience, is underappreciated by many stakeholders. A regulatory design that does not take this into account virtually guarantees that it will impose subtle but substantial costs of compliance without adding any corresponding benefit in the way of incremental greenhouse gas reductions. The MAC's recommendation for a "first seller" standard likely makes the best of a difficult situation, given the legislative mandate to account for the greenhouse gas attributes of generation imports in a "meaningful manner". California has been presented with an innately insoluble problem, mandated to impose a closed system regulatory regime on an open system.

Upon examination of the write-up, MSCG observed the following areas where we believe additional thought or clarification is merited:

Promotion of New Technologies

The MAC opines that the establishment of a cap and trade system does not eliminate the need for other policies "directly focused on promoting new technologies". We would posit that this conclusion is premature. Until a cap and trade regimen is in place for a time and has had a chance to work, the market failures cited to justify such "other policies" is purely speculative. While it is certainly possible that such market failures will materialize, MSCG does not believe sufficient evidence exists to make this a foregone conclusion. On the other hand, mandating additional programs that turn out to have been unnecessary will waste society's resources in a sort of "belt and suspenders" approach, and distort or reduce the ability of the market to provide allocative efficiency benefits.

Use of a "learning phase"

The MAC posits that it might be useful to utilize a "learning phase" as was done in the EU. While doing so would not be a disaster, we would submit that by the time the California program starts in 2012, there will be enough learning available from the EU, RGGI, and perhaps other programs that a California-specific "learning phase" will not be particularly useful. Sufficient attention to experiences in other jurisdictions during the design and run-up phase should allow a strong enough initial design to be implemented to make a full-fledged "learning phase" counterproductive. This is not to say that we assume the design will be "perfect" from day one, just that it is likely that any needed corrections will be of a magnitude that can be addressed with mid-course adjustments. The risk of a "learning phase" is that segregating an "early" period practice session from the eventual "real" program mutes the price signal benefits by the length of the phase. Parties contemplating long-term investments are likely to wait until they see a track record of prices from the "real" program before making investment decisions.

Additional Work Needed to Define the First Seller Proposal

The basic concept underlying the "first seller" approach strongly emphasizes focusing on source based emissions control, and allows the cost of the emissions to be injected into the economic dispatch decision. This is absolutely crucial for any system that hopes to make an actual difference in the physical dispatch of the generation system, and realize an actual reduction in greenhouse gas emissions. Clearly, however further refinements will be necessary before implementation. Perhaps these details are best left to a regulatory agency to develop via stakeholder processes in the design phase. However, we would feel remiss if we didn't at least mention two that come to mind.

First, in the context of in-state generation units, "first seller", as literally interpreted, may not be the best place to plane the compliance obligation. There are many complex contract arrangements in place that result in the "first seller" being someone other than the physical facility operator. In these cases, MSCG suggests that making it clear that the compliance obligation rests with the operator of the physical facility. The operator is best placed to measure and report emissions, although we recognize that contractual relationships can be used to clarify and allocate responsibilities between the operator and the "first seller".

Second, it is easy to say that the "first seller" has responsibility for demonstrating compliance for imports. However, figuring out HOW to do so is a much more complex problem. We would note that this problem is not unique to the "first seller" approach, but is innate in any approach that tries to establish the actual emissions attributable to power once detached from its source. The recommendation paper discusses that emissions attributed to imports would often need to be approximated, perhaps by using the average emissions intensity of the originating control area. It also muses that perhaps e-tags could be expanded and used to track energy form source to sink. However, many parties are opposed to expanding use of e-tags due to fear of negative impacts on reliability. Furthermore, e-tags themselves are, to a large extent, an administrative fiction, not a true physical tracking device. Even within the context of control-area based emission estimates, there is a debate with regard to whether it is most appropriate to use average or marginal emissions rates. MSCG does not yet have clear, final views on how best to address these problems within the context of a first seller approach, and perhaps the MAC considers this beyond its scope. However, to the extent it is able to do so, we believe stakeholders and the ultimate rules would benefit from a more extensive treatment of these issues by the Committee.

Distribution of Allowances

The MAC recommends ultimate distribution of all allowances via auction, with perhaps a partial allocation for a transition period. It discusses many rationales supportive of a partial allocation. It also mentions to a certain extent the possibility of using auction revenues to fund programs for such things as promotion of energy efficiency. In order to promote liquidity in the market from the start, and to ensure any party that needs an allowance can procure one, MSCG strongly endorses auctioning of all allowances. If it is felt that certain parties are unfairly burdened by having to purchase allowances, then those parties can be assigned Auction Revenue Rights (ARRs), providing cash rather than allowances. The Committee did not discuss this alternative at all in the paper, other than via an indirect statement that some people thought the government would do a better job of distributing allowances than money. Therefore MSCG in unaware of whether it was viewed as flawed by the MAC, and if so why, or simply not considered. We would urge that the Committee explicitly consider ARRs, and recommend their adoption rather than the partial allocation approach.

Offsets

MSCG strongly supports the use of offsets as compliance options. We recognize the valid concerns regarding the legitimacy and verifiability of many types of offsets. The proper way to address these concerns is to implement strong standards for qualification of offsets. Limitations on the use of qualified offsets is parochial and protectionist, and can cause society's resources to be squandered if the least cost options for reducing greenhouse gas emissions are not fully pursued. For these reasons, we applaud and support the Committee's recommendations to avoid restrictions on the use of otherwise qualified offsets.

Banking and Borrowing

MSCG supports the Committee's rationale and recommendations in favor of allowing banking and prohibiting borrowing.

Compliance Period

We believe the Committee has properly touched on the crucial issue here, which is timely and continuous release of information. While we would prefer a shorter compliance period than three years, we would concede that the exact compliance period is not crucial. However, release of information on allowance distributions, allowance surrenders and retirements, offsets used, and actual emissions measured and assigned, on an ongoing basis, IS crucial. The Committee endorses a period of no less often than quarterly reporting for "large" sources. MSCG would encourage the Committee to explicitly expand this recommendation to cover all sources, regardless of size, as well as include release of statistical information gathered by any and all regulatory agencies that receive such data or administer any aspect of the program.

Investment Signals

MSCG would recommend that the MAC address the issue of investment price signals in the context of the long-term allowance distribution plan. Consistent with our comments on the "learning phase" concept and the Compliance Period, we believe that the single most important thing is that the total amount of allowances to be distributed over a long time frame be agreed to, published, and maintained. Our experience suggests that a minimum ten year time frame would be very useful to investors for purposes of evaluating risks.

In conclusion, we wish to thank the Market Advisory Committee for all of its conscientious deliberations on the issues before it, and we appreciate the opportunity to participate in the process by providing our views. For further discussions or clarifications, please contact:

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